RB-1999-02 Guidance on Loan Participations

BACKGROUND

In recent months, high levels of liquidity have put greater pressure on credit union management to generate sufficient earnings to support operations. Because of this environment, some credit unions have elected to participate in loans with another credit union or organization. While there are many merits to participation lending, including the opportunity to diversify credit risk, it is an activity that requires strong policies and controls.

Credit unions must be diligent in underwriting participated loans or they may suffer unwanted consequences. Unfortunately, a few credit unions have failed to thoroughly investigate the terms and conditions of loan participation. As a consequence, they could very well incur losses because the true status of the purchased loan was either unknown, misunderstood, or misrepresented.

RESPONSIBILITIES

Credit unions have the following major responsibilities, both contractual and fiduciary, with regard to this type of lending:

1. Perform an independent analysis of the loan. The originating lender is responsible for obtaining all required documentation to comply with applicable state and federal laws. The originating lender should then provide copies of this information to each participating institution, and the participants are required to retain this information. We expect each party involved to

- perform an independent analysis of the loan and ensure that it meets their lending policies and standards.
- 2. Assess the source of repayment. It is paramount that each party involved independently assess the source of repayment. The originating lender is responsible for obtaining and distributing to participants a financial statement disclosing the borrower's ability to repay the loan, which is signed by the borrower and is current at the time that the loan application is made, or a written credit report prepared by the originating lender (or by others at the request of the lender). At the time an originating lender sells an interest in the loan, it must fully disclose to each participating institution all pertinent information in its possession concerning the financial condition of the borrower.
- 3. Review the participation agreement carefully. Although there are a number of ways a participation may be structured, the borrower customarily signs a note with the originating lender. The originating lender then sells an interest in that note to one or institutions pursuant to the terms of a participation agreement. The participation agreement is usually the key document that spells out in detail all terms, conditions, and understandings between the originating lender and the participant. The participation agreement ordinarily establishes which party is paid first, what happens in the event of default, how various expenses are to be divided, and who is responsible to collect the note in the event of default. Each participating credit union should carefully review participation agreements and records and ensure that the parties share in the risks and contractual payments on a pro rata basis.
- 4. Beware of informal repurchase agreements. Credit unions should be wary of informal repurchase agreements, "gentleman's agreements," and similar arrangements. A credit union and its legal counsel are expected to be fully aware of the extent of contingent liability

- associated with each participated loan and the manner in which the loan will be handled and serviced.
- 5. Monitor the status of the loan on an ongoing basis. Each participant should monitor the status of the loan on an ongoing basis by obtaining timely information from relevant sources. Analysis of loan participation quality should capture trends in volume, delinquencies, roll rates[1], charge-offs, cash collections, collateral valuations, bankruptcies and prepayments, cure or workout programs, and exceptions. The ability to perform the level of analysis warranted depends on the accuracy, completeness, and timeliness of information obtained from the seller or servicer. The participation agreement should specify what types of reports the participant should receive on a periodic basis, including any financial performance reports on the borrower and/or business entity which may be required by the originating lender as a condition for the loan. Each participant should understand the causes of identified shifts and trends in loan participation quality and document actions taken to mitigate increasing risk levels.
- 6. Maintain adequate records. For participations secured by real estate, copies of the borrower's application, note, a mortgage instrument or similar document, and an appraisal of the security property must be retained. Records of a participation interest not secured by real estate must also include copies of the borrower's loan application, note, and any documents evidencing creation of a security interest. Regardless of the type of loan security, a participant must also retain documentation of the currency of the loan on the date of purchase, any agreement concerning loan servicing, and a copy of the loan originator's underwriting standards.

Determining the adequacy of the special reserve requires detailed analysis using proper portfolio segmentation and loss estimation techniques. Reserve practices should be

sufficiently robust to protect against losses, taking into consideration actual loss experience, trends in borrower and collateral profiles, and any changes in business or economic conditions.

In addition to the above discussion, the following list gives the general duties of the originating lender and participants. Originating lenders have the responsibility to:

- Comply with the participation agreement, consents required, and other contractual duties;
- Provide accurate, complete, and timely required reports and documents to the participant;
- Keep the participant informed of legal/business issues related to the borrower;
- Refrain from any activities that might be construed as competitive with the participant (e.g., make a loan directly to the borrower that is secured by a second lien on the collateral property underlying the participation); and
- Exercise similar controls and procedures over participations sold as for loans in its own portfolio.

Credit unions purchasing participation loans have the responsibility to:

- Ensure that adequate documentation is obtained and an independent analysis of credit quality is properly performed;
- Evaluate the risk of the proposed investment to determine whether the loan participation is consistent with the credit union's portfolio strategy and risk tolerance
- Monitor the participation to ensure that the originating lender is fulfilling its duties and responsibilities;
- •Obtain records in connection with loan participation

- purchases, including copies of such items as applications, notes, deeds of trust, and appraisals; and
- Subject participation loans purchased to the same critical review and documentation requirements as those loans originated by the credit union.

CONCLUSION

Each credit union is expected to have lending policies[2], practices, procedures, and internal controls that ensure that each participated asset is evaluated for credit quality, collectability, and collateral sufficiency, and that it is in compliance with regulatory standards. Following safe and sound participation lending practices will help assure adequate revenues and prevent unexpected losses.

- [1] Roll rates refer to the movement of accounts from one payment status to another; e.g., the percentage of 60-days-past-due accounts that "roll" to 90 days past due or, conversely, from 60 days past due to current. Calculations should capture both forward (worsening) and backward (improving) performance.
- [2] Each credit union is expected to conduct its lending/investment activities prudently. Each institution should use lending and investment standards that are consistent with safety and soundness principles and are appropriate for the size and condition of the institution, the nature and scope of its operations, and conditions in its community. At a minimum, the credit union's policies for loan participations should set limits on the amount of risk that

will be assumed — in total and by originating lender, address how the credit union will control portfolio quality, and avoid excessive exposure.